APPENDIX A

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

MARCH TERM, 1957

Filed Apr. 19, 1957

No. 5465

AINSLIE PERRAULT and MAE FRANCES PERRAULT, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5466

R. M. GUNN, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5467

ALMA L. GUNN, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5468

R. M. GUNN, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5469

ARTHUR T. SAUNDERS, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5470

MARGUERET A. SAUNDERS, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5471

ARTHUR T. SAUNDERS and MARGUERET A. SAUNDERS, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5472

R. E. STANFORD, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5473

PEGGY Q. STANFORD, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5474

AINSLIE PERRAULT, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5475

MAE FRANCES PERRAULT, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 5476

ALLIED PAINT MANUFACTURING CO., *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

On Petitions to Review the Decisions of The Tax Court of the United States

Graham Loving, Jr., Oklahoma City, Oklahoma, (Louis Eisenstein, Washington, D. C., and James D. Fellers, Oklahoma City, Oklahoma, were with him on the brief) for Petitioners.

David O. Walter, Washington, D. C., (Charles K. Rice, Assistant Attorney General, Lee A. Jackson and A. F. Prescott, Attorneys, Department of Justice, Washington, D. C., were with him on the brief) for Respondent.

Before HUXMAN, MURRAH, and LEWIS, Circuit Judges.

PER CURIAM.

Petitioners seek to review decisions of the Tax Court involving the personal income tax liabilities of the individual petitioners for the years 1946 and 1948 and the corporate income tax liability of the Allied Paint Company for the years 1947, 1948, and 1949. The Tax Court has determined that income claimed by the individual petitioners as proceeds from a sale and taxable as a capital gain should be treated as dividend income and subject to normal rates.[1] The corporate adjustments are routine if the Tax Court's position is sound as applied to the individual petitioners.

The basic transaction giving rise to the instant dispute is the identical transaction involved in this court's con-

[1] The findings and opinion of the Tax Court are reported at 23 TC 424 and 25 TC 439.

sideration of Houck v. Hinds, 215 F. 2d 673. The individual parties here were partners of Houck whose case was considered on appeal for claim of refund for the year 1946. The substantive question presented is identical and, in reliance upon Houck, the Tax Court has reached the same conclusions and result as we affirmed in that case.

Although petitioners have elaborately briefed the case they can draw no factual or legal distinction of significance between the two cases. In Houck the findings of fact were sustained by this court without examination because the record did not contain the transcript of testimony below. In the present case the record is complete and the findings, adequately supported by the evidence, are substantially the same.

The decision of the Tax Court of the United States in each case is AFFIRMED.

25 T. C. No. 54

THE TAX COURT OF THE UNITED STATES

R. M. GUNN, et al.,[1] *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

[1] Proceedings of the following petitioners are consolidated herewith: Alma L. Gunn, Docket No. 40659; R. M. Gunn, and Alma L. Gunn, Docket No. 40660; Arthur T. Saunders, Docket No. 40661; Margueret A. Saunders, Docket No. 40662; Arthur T. Saunders and Margueret A. Saunders, Docket No. 40663; R. E. Stanford, Docket No. 40664; Peggy Q. Stanford, Docket No. 40665; Ainslie Perrault, Docket No. 40666; Mae Frances Perrault, Docket No. 40667, and Allied Paint Manufacturing Company, Docket No. 40671. The issues in Docket Nos. 40666 and 40667 are also involved in Ainslie Perrault and Mae Frances Perrault, Docket No. 40668, which this Court has heard, together with other consolidated proceedings. It is agreed that the Court's determination in Docket Nos. 40666 and 40667 will be binding in Docket No. 40668.

Docket Nos. 40658-40667, 40671.

Filed December 9, 1955.

In June 1946, the general partner of a going business consulted a tax attorney in regard to the possible sale of the business then being conducted by the general partner and four special partners. Such consultations resulted in the attorney organizing a new corporation on September 21, 1946, with himself and his associate subscribing for all of the capital stock in the amount of $50,000, $1,000 of which was paid for in cash. On October 1, 1946, the partners, as vendors, and the corporation, as vendee, executed a "Bill of Sale" wherein the partnership assets having a book value of $325,584.55 (adjusted by respondent to $352,050.60) were transferred to the corporation for $582,773.54 payable in notes of the corporation. The notes were issued to the partners on the basis of the same proportionate interest as each partner had in the partnership. Fifty thousand dollars of the notes were payable on December 31, 1946, without interest and the balance in ten annual equal payments on January 2 of each of the years 1948 to 1957, both inclusive, with interest at three per cent. The attorney had hoped, through the corporation, and with the general partner's assistance, to make a quick resale of either the assets or stock at a substantial profit. In case of a resale the general partner was to be paid some undetermined commission. But before this could be accomplished the attorney decided he wanted to withdraw from the transaction and persuaded the general partner (who acted for himself and the other four partners) to permit him and his associate to step out and withdraw from the entire transaction, whereupon the general partner (acting for himself and the other four partners), on October 18, 1946, paid the attorney $1,000 for the stock the attorney had paid for and subscribed for the remaining $49,000 of stock, thus relinquishing any subscription obligation the corporation may have had against the attorney. All of this stock was then issued

to each of the partners in the same proportionate interest as each partner had in the partnership. On the basis of the facts, more fully set out in our findings, it is *held*:

1. In substance what occurred in October 1946 was a single transaction wherein the partners transferred their partnership property, including their subscriptions for stock, to a corporation solely in exchange for stock and notes.

2. In substance the notes constituted a proprietary interest in the corporation rather than indebtedness.

3. In substance the transfer to the corporation was such a transfer as is dealt with in section 112(b)(5) of the Internal Revenue Code of 1939. *Houck* v. *Hinds*, 215 F. 2d 673, followed.

4. The amounts received by the stockholders in 1946 and 1948 as payments on the notes were in substance dividends rather than proceeds from a sale.

5. The corporation is not entitled to deduct interest paid or accrued on the notes since the notes did not represent indebtedness.

6. The basis for depreciation to the corporation of the property acquired from the partners is the same as it would be in the hands of the transferors. Section 113(a)(8), Internal Revenue Code of 1939.

Randolph E. Paul, Esq., Louis Eisenstein, Esq., James D. Fellers, Esq., and *Graham Loving, Esq.*, for the petitioners.

John P. Higgins, Esq., for the respondent.

In Docket Nos. 40658 to 40667, inclusive, respondent determined deficiencies in income tax for the calendar years 1946 and 1948, as follows:

Petitioner	1946	1948
R. M. Gunn	$2,061.77	—
Alma L. Gunn	2,061.77	—
R. M. Gunn and Alma L. Gunn	—	$2,126.06
Arthur T. Saunders	1,321.39	—
Margueret A. Saunders	1,340.39	—
Arthur T. Saunders and Margueret A. Saunders	—	1,352.96
R. E. Stanford	1,349.91	—
Peggy Q. Stanford	1,293.66	—
Ainslie Perrault	9,500.54	—
Mae Frances Perrault	9,371.31	—

In Docket No. 40671, respondent determined deficiencies in income tax for the fiscal years ending September 30, 1947, 1948 and 1949, as follows:

Petitioner	1947	1948	1949
Allied Paint Manufacturing Co.	$8,638.48	$9,028.12	$7,643.22

In Docket Nos. 40658 to 40667, inclusive, the only issue, common to all the petitioners, is whether certain payments on notes by the Allied Paint Manufacturing Co. to petitioners are taxable to the individual petitioners as the proceeds of an installment sale, as contended for by the petitioners, or as dividends, as determined by the respondent.

In Docket No. 40671, two issues are involved: (1) whether amounts accrued as interest on the above-mentioned notes are deductible by petitioner Allied Paint Manufacturing Co., and (2) whether the basis for depreciation to petitioner Allied Paint Manufacturing Co. on certain assets acquired from the individual petitioners as partners in a partnership is the cost of such assets to the Allied Paint Manufacturing Co. or the prior basis of such assets in the hands of the partnership.

Findings of Fact

The stipulation of facts is incorporated herein by this reference.

Petitioners R. M. Gunn and Alma L. Gunn, Arthur T. Saunders and Margueret Saunders, R. E. Stanford and Peggy Q. Stanford, and Ainslie Perrault and Mae Frances Perrault are, respectively, husband and wife. Each couple filed separate income tax returns for the calendar year 1946. Petitioners R. M. Gunn and Alma L. Gunn, Arthur T. Saunders and Margueret Saunders, and Ainslie Perrault and Mae Frances Perrault filed joint income tax returns for the calendar year 1948. All these returns were filed with the collector of internal revenue for the district of Oklahoma. R. M. Gunn, Arthur T. Saunders, R. E. Stanford and Ainslie Perrault are sometimes hereinafter referred to as the petitioners.

Petitioner Allied Paint Manufacturing Co. is a Delaware corporation with principal offices at Tulsa, Oklahoma. It filed its income tax returns for the fiscal years ending September 30, 1947, 1948 and 1949, with the collector of internal revenue for the district of Oklahoma. It keeps its books and reports its income on an accrual basis of accounting.

On February 27, 1939, a corporation known as Allied Paint Company was organized under the laws of the state of Oklahoma, with an authorized capital of $50,000. It engaged in the business of manufacturing and selling paint and related materials. On May 31, 1943, the corporation was liquidated and dissolved. Its stockholders then continued the same business as a limited partnership under the name of Boylan-Perrault Company, doing business as Allied Paint Company. The general partners were David M. Boylan and Ainslie Perrault, who had equal interests of 38.571 per cent. The special partners were Arthur T. Saunders, R. M. Gunn, R. E. Stanford, and George C. Houck, Jr. Under the articles of partner-

ship the survivor of the two general partners had an option to acquire the other's interest at book value, as shown by the last semi-annual audit before death.

On or about October 19, 1943, Boylan was killed in military service. On October 21, 1943, the surviving partners formed a limited partnership which took over the business under the name of Ainslie Perrault, doing business as Allied Paint Company. Ainslie Perrault was the general partner and the other four were special partners. On April 1, 1946, the partners executed a new agreement to conduct the business as Allied Paint Company, hereinafter referred to as the Partnership. Ainslie Perrault continued as general partner and the others as special partners. Their distributive interests were as follows:

Ainslie Perrault	55.00%
R. M. Gunn	17.50
Arthur T. Saunders	12.50
R. E. Stanford	12.50
George C. Houck, Jr.	2.50

The Partnership reported its income on the basis of an accrual method and a fiscal year ending September 30th.

The agreement of April 1, 1946, provided that upon the death of the general partner, the surviving partners had an option to purchase his interest at book value as of the last day of the month preceding the date of his death. Under the terms of the agreement it was contemplated that the Partnership would carry $30,000 of insurance on the life of the general partner, and that the insurance proceeds would be applied toward the payment of the purchase price. If a special partner died, the survivors had a similar option to purchase his interest at book value. The agreement further permitted the general partner, on behalf of himself or the Partnership, to buy the interest of any special partner for an amount equal to 110 per cent of its book value, as reflected by the last semi-annual audit.

The net profits of the business conducted by these various organizations until September 30, 1946, as reflected on the books of account and before adjustments by the respondent, were as follows:

Period From	Period To	Net Profits	Federal and State Taxes	Net After Taxes
3/ 6/39	11/30/39	($ 621.71)	——	$ ($ 621.71)
12/ 1/39	11/30/40	1,411.34	$ 268.00	1,143.34
12/ 1/40	11/30/41	42,964.75	16,954.63	26,010.10
12/ 1/41	11/30/42	58,886.16	34,498.62	24,387.54
12/ 1/42	5/31/43	17,907.44	10,920.62	6,986.82
6/ 1/43	10/20/43	52,146.82	——	52,146.82
10/21/43	9/30/44	91,862.97	——	91,862.97
10/ 1/44	9/30/45	63,663.00	——	63,663.00
10/ 1/45	9/30/46	136,540.96	——	136,540.96

The following table shows the earnings, as adjusted by the respondent, and the average annual net assets of the business between February 27, 1939, and September 30, 1946:

Period From	Period To	Earnings For Period	Average Annual Net Assets.
2-27-39	11-30-39	($ 121.71)	$ 49,939.15
12- 1-39	11-30-40	1,340.83	54,199.96
12- 1-40	11-30-41	41,858.16	75,626.68
12- 1-41	11-30-42	58,209.28	109,058.15
12- 1-42	5-31-43	21,427.06	124,040.75
6- 1-43	10-20-43	76,342.53	144,693.22
10-21-43	9-30-44	123,974.46	148,675.00
10- 1-44	9-30-45	112,938.63	167,017.34
10- 1-45	9-30-46	188,971.03	267,349.30

The net assets of the business increased from $50,000 on February 27, 1939, to $331,634.41 on September 30, 1946.

In early June 1946, Ainslie Perrault consulted L. Karlton Mosteller, an attorney engaged in practice in Oklahoma City. The two had not known each other previously. Perrault sought Mosteller's advice in regard to the options to acquire the interest of a deceased partner at book value. He informed Mosteller that the business was worth much more than its book value. Under a similar option Boylan's

estate had received approximately the book value of his interest, and Perrault was concerned that his own estate or the estates of other partners would suffer the same way. He was particularly disturbed at that time because of his poor health. He was extremely overweight, and a severe arthritis affected the joints of his knees, back, arms and hands. His doctors had advised him to curtail his business activities. He spent only two or three hours at the office and was unable to do much work. Mosteller made several tentative recommendations, including a suggestion that the option price be based on the fair market value of the assets at the date of death.

Perrault and Mosteller continued to meet periodically during the summer of 1946. Their discussions broadened into a general consideration of the paint industry and its prospects in the near future. Perrault pointed out that during the war the manufacture of paint equipment and supplies had generally ceased. Though the war had ended, there were still serious shortages in equipment and raw materials, especially pigments. According to Perrault, the outlook for the industry was extremely good. Paint sales were expected to rise because there had been little painting for five or six years. Since Perrault's health was poor, and paint and paint equipment were in great demand, Mosteller finally advised him that the best solution was to sell out at a substantial profit. Perrault argued that the low book values of the assets made it virtually impossible to obtain what he considered a fair price. In response to this difficulty Mosteller suggested that the assets be transferred tax-free to a corporation, and that the assets be set up on the corporate books at their current value. Perrault maintained that the mark-up would mean little to a purchaser, for it would not reflect a true monetary cost. However, toward the end of July 1946 Perrault became more optimistic about the possibility of selling the business.

Mosteller and his law partner George H. McElroy were engaged in a number of business ventures. They had a considerable stake in the Empire Life Insurance Company, which they had helped organize in Oklahoma. They were financially interested in the development of an airport, an apartment house project and another housing project. They were also involved in a radio station. In view of Perrault's increasing optimism Mosteller became personally interested in acquiring the business and reselling it at a quick profit. Mosteller indicated that he and McElroy would be willing to buy the business on credit for as favorable a price as the Partnership could obtain from anyone else. Perrault agreed to take up the matter with his partners. A few days later Mosteller and Perrault conferred again. Perrault stated that various larger companies were interested in buying smaller companies, especially companies like the Partnership which had a favorable quota for raw materials. He mentioned the possibility of selling the business at $750,000 to the Phoenix-Whitney Company or the Paraffin Corporation. After further discussion Mosteller and Perrault decided that they would try to work out a sale. Mosteller asked Perrault and his partners to prepare a list of the assets and to name a price.

Petitioner Saunders prepared an itemized list of the assets, which came to a total price of about $735,000. Mosteller regarded that amount as too high and negotiations continued through August into early September. The principal difference of opinion centered on an item called "Formulae and Manufacturing Processes." These formulae and processes represented special paint coatings which had been developed to suit the individual needs of various industrial concerns. The business was then grossing almost $1,000,000, of which about half was attributable to sales of the coatings. The Partnership wanted $250,000 for them, but Mosteller was unwilling to consider them at more than $100,000. After considerable argument Mos-

teller finally declared that the proposed transaction was off unless the price for the formulae and processes was reduced to $100,000. He stated that the total price for all the assets would have to be about $582,000, and that he and McElroy would go ahead only on that basis. A day or so later Perrault advised Mosteller that the partners had decided to let a new corporation to be formed by Mosteller take the business over at about $582,000. Mosteller and McElroy had hoped to resell the property at a higher price, perhaps $750,000. They figured that they would be able to dispose of the assets within about 30 days and that they might net about $100,000. Neither had any intention of staying in the paint business.

On September 21, 1946, Mosteller and McElroy organized the petitioner Allied Paint Manufacturing Co., hereinafter referred to as the Corporation. Its authorized capital was $50,000, consisting of 10,000 shares with a par value of $5 per share. On September 24, 1946, Mosteller, McElroy and Richard G. Taft became directors of the Corporation. On October 1, 1946, they were respectively elected president, vice-president, and secretary-treasurer. On the same date, Mosteller subscribed for all the authorized shares on behalf of himself and McElroy, and a certificate for 10,000 shares was issued to him. At that time Mosteller paid the Corporation $1,000 for 200 shares and signed a subscription agreement for the other 9,800 shares, in which he promised to pay the balance of $49,000 on demand.

On October 1, 1946, the Corporation agreed to buy the assets, free and clear of all liabilities, for $582,773.54. The minutes of the first directors' meeting, held on the same date, recorded that Mosteller "had concluded negotiations for the purchase of certain personal and real property" from the petitioners and George C. Houck, Jr., "being all of the properties formerly used by them as partners trading as Allied Paint Company, a copartnership, said properties having heretofore been withdrawn

by them from said copartnership." The minutes noted that the total sales price for the properties was $582,773.54, to be represented by notes; that $50,000 was payable on or before December 31, 1946, and the balance in ten annual equal installments beginning on January 2, 1948; that the price "had been arrived at as a result of extended and careful consideration and negotiations"; and that it was "fair and reasonable, especially in the light of prevailing conditions and circumstances." In regard to the terms of sale the minutes further noted that "as part of the transaction" the Corporation was obliged to secure the installments payable to Perrault by a mortgage on its assets and a policy of $125,000 on his life if he was insurable. The board of directors approved the proposed purchase and authorized the officers to complete it. The board also authorized them to open an account with The First National Bank & Trust Company of Tulsa.

On and after October 1, 1946, the special partners continued to conduct the operations of the business and Perrault continued trying to find a purchaser either for the assets transferred to the Corporation or for the stock of the Corporation.

The balance sheet of the Partnership as of September 30, 1946, prior to adjustments required by changes made by the revenue agent's examination which are not in controversy, reflected total assets of $351,552.11, total liabilities of $47,207.54, and a net worth of $304,344.57.

On October 1, 1946, the Partnership distributed to the partners all its fixed assets and inventories, and accounts and notes receivable of a total depreciated book value of $325,584.55, thus leaving in the partnership cash of $15,384.35, other assets of $10,583.21 and the liabilities of $47,207.54. On the same day the partners executed a bill of sale to the Corporation covering the same assets that had been distributed to the partners. A summary of the depreciated value of the assets on the books of the

partnership, as adjusted by the respondent, and as included in the bill of sale, is as follows:

Asset	Partnership Books	As Adjusted	Bill of Sale
Land	$ 3,312.38	$ 7,439.20	$ 8,500.00
Buildings, Machinery and Equipment	60,679.97	83,019.20	212,681.34
Receivables	104,068.75	104,068.75	104,068.75
Inventories	157,523.45	157,523.45	157,523.45
Processes & formulae	None	None	100,000.00
Totals	$325,584.55	$352,050.60	$582,773.54

The Corporation promised to pay $50,000 on or before December 31, 1946, and the balance of $532,773.54 in ten annual equal installments on January 2d of each of the years 1948 to 1957. The fair market value of the assets transferred to the Corporation was not less than $582,773.54.

At the time of the sale, the Corporation issued two notes to each of the vendors as follows:

Payees	Notes Due Dec. 31, 1946	Ten Year Installment Notes	Total
Ainslie Perrault	$27,500.00	$293,025.45	$320,525.45
R. M. Gunn	8,750.00	93,235.37	101,985.37
Arthur T. Saunders	6,250.00	66,596.69	72,846.69
R. E. Stanford	6,250.00	66,596.69	72,846.69
George C. Houck, Jr.	1,250.00	13,319.34	14,569.34
	$50,000.00	$532,773.54	$582,773.54

The notes due on December 31, 1946, were non-interest bearing. The other notes, payable in ten annual installments beginning on January 2, 1948, carried interest at three per cent from December 31, 1946. Upon default in the payment of any installment, the holder could declare the entire balance due. The Corporation, as maker, re-

served the right to pay any installment before its due date. On October 1, 1946, the Corporation executed a combination real estate and chattel mortgage in favor of Perrault. The mortgage secured his installment note of $293,025.45, and covered present and future assets of the Corporation. The notes of the other partners were not secured.

On October 12, 1946, Mosteller went to Tulsa for a meeting with Perrault. At this meeting he told Perrault that he and his associate did not wish to continue any longer in the position they were in with regard to the Corporation. Perrault tried to persuade Mosteller to continue on with the transaction for a few months longer but Mosteller refused. Finally, on October 18, 1946, Perrault paid Mosteller $1,000 for the stock Mosteller had paid for, whereupon Mosteller stepped out of the transaction after the Corporation had accepted subscriptions from the five partners for the remaining authorized capital stock of $49,000, thus relinquishing any subscription obligation it may have had against Mosteller. The Corporation, on October 18, 1946, issued to each of the five stockholders a certificate for his respective number of shares, as follows:

Stockholder	Shares	Par Value	Per Cent of Total
Ainslie Perrault	5,500	$27,500	55.00%
R. M. Guinn	1,750	8,750	17.50
Arthur T. Saunders	1,250	6,250	12.50
R. E. Stanford	1,250	6,250	12.50
George C. Hoick, Jr.	250	1,250	2.50
Total	10,000	$50,000	100.00%

After the meeting between Mosteller and Perrault on October 12, 1946, Perrault was placed on the payroll of the Corporation as of October 1, 1946.

The stockholders gave the Corporation notes covering their subscriptions for its stock. They made payments on the notes as follows:

1948	$9,800
1950	9,800
1952	5,000
1953	5,000

The stockholders have always been prepared to make full payment on their subscriptions. They have been paying interest on their obligations under the subscription agreements.

For the fiscal year ending September 30, 1947, the Partnership reported interest income of $1,026.99 and a loss in the same amount. Its balance sheet at the end of that year showed no assets and $15,110.10 of liabilities.

The Corporation has carried on the same business as the Partnership since October 1, 1946. For the fiscal years 1947 through 1952 its sales and net profits, before adjustments by the respondent, were as follows:

Year	Sales	Net Profits	Federal and State Taxes	Net Profits after Taxes
1947	$1,219,780.22	$259,761.65	$103,922.03	$155,839.62
1948	1,331,348.20	141,469.87	56,203.50	85,266.37
1949	1,388,483.74	117,767.54	48,296.15	69,471.39
1950	1,647,547.73	191,943.87	79,547.08	112,396.79
1951	2,106,964.45	268,750.46	161,587.57	107,162.89
1952	2,115,974.84	209,198.55	116,375.28	92,823.27

The paint manufacturing business is a seasonal industry. It is active in the spring, summer and early fall, and inactive during the rest of the year. Materials are usually purchased about three to six months before the active period of manufacture and sale begins. Because of the seasonal nature of the business there is usually a seasonal fluctuation of debt. During the winter months, when business is low, the companies borrow money to finance the purchase of inventory. Later, in the peak months, the loans are repaid. Like other companies of similar size, the Partnership regularly obtained seasonal bank loans on short-term notes to help carry its inventory. The

Corporation continued to do the same, and had no trouble in obtaining credit for its purchases. The bank has never criticized the Corporation for its liability on the notes held by the stockholders.

The following schedule reflects the bank loans owed on the following dates between November 30, 1939, and March 31, 1954:

Date	Amount
November 30, 1939	$ 4,000.00
May 31, 1940	14,700.00
November 30, 1940	5,100.00
May 31, 1941	3,000.00
May 31, 1942	40,000.00
October 20, 1943	9,400.00
September 30, 1945	15,000.00
March 31, 1946	40,000.00
March 31, 1948	63,000.00
September 30, 1948	95,000.00
March 31, 1949	125,000.00
September 30, 1949	30,000.00
March 31, 1950	50,000.00
September 30, 1950	25,000.00
March 31, 1952	120,000.00
March 31, 1953	73,000.00
March 31, 1954	143,000.00

For September 30, 1945, to March 31, 1954, the table indicates the bank loans outstanding at the end of each six-month period of the fiscal year. Where the last date of of a six-month period is missing, the omission indicates that there was no borrowing in that period. For example, there were no bank borrowings in the six-month periods ending September 30, 1946, March 31, 1947, and September 30, 1947. As the table indicates, after March 31, 1948, there was an increase in borrowing which reached $125,000 as of March 31, 1949. This increase was due to an unusual sales expansion in 1948. The Corporation greatly enlarged its sales territory, acquired a retail outlet in Oklahoma City for about $75,000, and employed four or five additional salesmen at about $10,000 each. By September 30, 1949,

the borrowings had been reduced to $30,000. The $125,000 was borrowed on two-year notes which were paid in less than a year.

The balance sheets of the Corporation at the end of its fiscal years 1947 through 1949 reflected the following cash and receivables, and earned surplus:

Year	Cash and Receivables	Earned Surplus
1947	$313,227.67	$155,839.62
1948	302,210.69	237,407.92
1949	308,208.15	309,907.62

The Corporation paid in full the notes due on December 31, 1946. It paid the annual installments on the 10-year notes through 1952. The 1948 payments amounted to $53,277.35. Since the respondent has treated the payments as dividends, all further payments of principal on the latter notes have been deferred pending a judicial determination whether his position is correct. The Corporation has had sufficient funds to pay the installments past due.

On June 17, 1947, the Corporation succeeded in obtaining a policy of special risk on Perrault's life in the amount of $125,000. It then assigned the policy to him as collateral security for his installment note. The mortgage securing his note has not been recorded.

All interest on the installment notes has been regularly paid as follows:

January 12, 1948	$532,773.54 at 3% From 1/ 2/47 to	12/31/47	$15,983.20
December 9, 1949	$429,496.19 at 3% From 1/ 2/48 to	1/ 2/50	28,769.86
December 8, 1950	$372,941.49 at 3% 1/2/50 to	9/30/50	9,589.95
November 14, 1951	$372,941.49 at 3% From 10/ 1/50 to	9/30/51	11,188.24
October 30, 1952	$319,664.14 at 3% From 10/ 1/51 to	9/30/52	9,589.93
December 8, 1953	$266,386.79 at 3% From 11/ 1/52 to	9/30/53	7,991.16

The interest accrued for the Corporation's fiscal year 1947 was $11,987.40. It was paid on January 12, 1948. The interest accrued for its fiscal year 1948 was $13,659.47. Of this amount, $3,995.80 was paid on January 12, 1948, and $9,663.67 on December 9, 1949. The interest accrued for its fiscal year 1949 was $14,384.93. It was paid on December 9, 1949.

The petitioners treated the payments received on their notes in 1946 and 1948 as the proceeds of a sale, and reported long-term capital gains on the installment basis. The respondent determined that the payments were dividends from the Corporation.

In its return for its fiscal years 1947, 1948 and 1949, the Corporation deducted the interest accrued on the notes in those years. The respondent disallowed the deductions on the ground that they represented "interest on capital stock." With respect to the fiscal years 1947 and 1948 the Commissioner further held that if the interest "was paid on indebtedness, it still would not constitute an allowable deduction because of the provisions of section 24(c) of the Internal Revenue Code."

The Corporation's depreciation deductions for its fiscal years 1947, 1948 and 1949 were based on its cost for the depreciable assets under the bill of sale. The respondent determined that the basis was the same as the Partnership's basis for the assets. He also held that the depreciation allowed by him was "reasonable regardless of the manner of acquisition of the depreciable assets" which the Corporation "acquired upon incorporation." The rates of depreciation used by the Partnership and the Corporation are not in dispute.

In their original 1946 income tax return, the stockholders reported no profit from the transfer of their Partnership assets to the Allied Paint Manufacturing Company. In amended 1946 income tax returns the stockholders reported a profit from the transfer of their Part-

nership assets to the Allied Paint Manufacturing Company as capital gain, electing to use the installment sale method of computing the gain.

No formal dividends as such were paid in 1946, 1947 or 1948 by the Corporation to the stockholders.

Mosteller did not complete the understanding had with Perrault for a quick resale of the property by the Corporation (or a quick sale of the Corporation's stock), but induced Perrault to permit him (Mosteller) to step out of the entire transaction. Thereupon, all of the former partners subscribed for stock of the Corporation in exactly the same proportion as was their interest in the Partnership. What occurred during October 1946 was in substance a single transaction whereby the partners subscribed for stock in a new Corporation and transferred their Partnership property to the Corporation for notes, with both the stock and the notes representing the same proportionate interest in the Corporation as they previously held in the Partnership.

The purchase money notes given by the Corporation to its controlling stockholders at the time of incorporation constituted a portion of the stockholders' proprietary investment in the Corporation.

Payments on the principal amounts of the purchase money notes given by the Corporation to its controlling stockholders at the time of incorporation constituted the distribution of taxable dividends.

Accruals on the purchase money notes given by the Corporation to its controlling stockholders at the time of incorporation were not deductible as interest payments.

The basis of property acquired by the Corporation in exchange for stock issued to the controlling stockholders at the time of incorporation is the same as the basis of the property in the hands of the transferors.

OPINION

ARUNDELL, *Judge:* The issues for our decision arise from a series of happenings in 1946 among five partners of a limited Partnership operating under the name of the Allied Paint Company, their legal advisors, Mosteller and McElroy, and a newly formed Corporation called Allied Paint Manufacturing Company.

As set forth in our findings, we have determined that these happenings must be treated as parts or steps in a single transaction. So regarded, the several individual partners must be held to have transferred their interest in the Partnership assets to the Corporation and thereafter to have controlled the Corporation in the same proportion that they held the Partnership assets. This would place the transaction as one falling under section 112(b)(5) of the Internal Revenue Code of 1939,[2] in which no gain or loss would be recognized.

This was the holding of the District Court for the Western District of Oklahoma and the Court of Appeals for the Tenth Circuit, which affirmed that decision in *Houck* v. *Hinds*, 215 F. 2d 673. Houck was one of the special partners in the partnership with which we are here dealing and the transaction passed on by the Court of Appeals is the identical one with which we are here concerned. Our findings of fact are substantially like

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[2] SEC. 112. RECOGNITION OF GAIN OR LOSS. (b) Exchanges Solely in Kind.—

"(5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

those made by the District Court and considered on appeal and we agree with the conclusion of these Courts that insubstance what actually occurred was a single transaction wherein the five partners transferred their partnership property to a corporation solely in exchange for notes totaling $582,773.54, and at the same time subscribed for all of the corporate stock. Cf. *Commissioner v. Court Holding Co.*, 324 U.S. 331.

Our next question is to determine whether the notes totaling $582,773.54 constituted evidence of indebtedness or whether they constituted evidence of the stockholders' proprietary interest in the business in the nature of "stock" as that term is used in section 112(b)(5) of the 1939 Code. While they were in the form of notes, they were in direct proportion to the stock subscriptions and to the partners' interest in the Partnership. In determining whether the relationship of the noteholders to the Corporation is proprietary or debtor-creditor, we must look at all the circumstances surrounding the creation of the Corporation and the execution of the notes and not merely the form that was adopted. *Higgins v. Smith*, 308 U.S. 473; *Proctor Shop, Inc.*, 30 B.T.A. 721, aff'd. 82 F. 2d 792. We note that each partner subscribed for identically the same proportionate interest in the Corporation as he held in the partnership and received a like proportionate interest in the notes. Although the average annual net assets or capital of the business increased gradually from $49,939.15 in 1939 to $267,349.30 in 1946, the only form-capital the Corporation had was $1,000 in cash and $49,000 in stock subscriptions. This was a ratio of form-indebtedness to form-capital of about 11 to 1. This ratio would tend to indicate that under the circumstances here present the relationship between the Corporation and the noteholders might well be proprietary rather than debtor-creditor. *Swoby Corporation*, 9 T.C. 887; *R. E. Nelson*, 19 T.C. 575; *Isidor Dobkin*, 15 T.C. 31, aff'd. 192 F. 2d 392.

Petitioners argue that the notes should not be treated as risk capital because they were payable at a fixed time and were not, according to the petitioners, put to the risk of the business in the same manner that capital was. This position is not realistic. This case is not one where capital, in addition to that specifically covered by the notes and stock, is contributed to the Corporation for its use in operations as was found in *Sheldon Tauber*, 24 T.C. (May 9, 1955). In the *Tauber* case, over $150,000 of assets were transferred to the corporation in addition to the assets transferred for stock and notes.

It is also interesting to note that payment on the notes ceased as soon as the respondent determined that such payments constituted dividends rather than proceeds of a sale. In this respect, the notes bear a close resemblance to the notes involved in *Gooding Amusement Co.*, 23 T.C. 408 (on appeal, C.A. 6) where certain of the noteholders displayed an intention of not enforcing payment of their notes or asserting the rights of bona fide creditors.

After careful consideration of the several criteria referred to above, it is our conclusion and holding that the notes in question constituted in substance a proprietary interest in the Corporation in the nature of stock rather than a bona fide indebtedness.

Petitioners contend that section 112(b)(5) is not applicable because that section applies "only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange." In this connection, petitioners argue that because the partnership agreement permitted the general partner to buy the interest of any special partner for an amount equal to 110 per cent of its book value and because, as noteholders, the special partners had an assured interest in the appreciated value of the business and as stockholders they would share in the future growth of the business, unencumbered by Perrault's power to buy them

out, their interests expanded and Perrault's interest contracted. We see no merit in this argument. Since Perrault (the general partner) at no time elected to buy out any of the special partners, the interests of the latter remained as they were and they received the same percentages of notes and stock. We hold for the respondent on this point. *Houck* v. *Hinds, supra.*

Since we have held that the so-called notes payable to the stockholders did not constitute a valid indebtedness of the Corporation but represented capital invested in the business, and since the Corporation had sufficient accumulated earnings with which to make the payments on the notes which were made in 1946 and 1948, we think it follows that such payments were dividends under section 115(a) or (g) of the 1939 Code, and that it is not necessary in this Opinion to determine whether the payments were dividends under subsection (a) or subsection (g) of section 115. They were dividends under one or the other of the subsections and that is all that is necessary for us to decide. See *Emil Stein*, 46 B.T.A. 135; *Gooding Amusement Co., supra*; *Houck* v. *Hinds, supra.*

The second issue is whether amounts accrued as interest on the above-mentioned notes are deductible by the Corporation as "interest paid or accrued within the taxable year on indebtedness" under section 23(b) of the 1939 Code. The respondent also contends that in any event section 24(c) of the 1939 Code is applicable. Having held under the first issue that the notes did not constitute "indebtedness" of the Corporation, it follows that the Corporation is not entitled to any deduction for interest paid or accrued on such notes. It thus becomes unnecessary to consider the respondent's contentions under section 24(c).

The third and final issue is whether the basis for depreciation to the Corporation on the assets acquired from the five partners is the cost of such assets as set out in

the bill of sale or the prior basis of such assets in the hands of the transferors under sections 114(a), 113(b) and 113(a)[3] of the 1939 Code. Since we have held under the first issue that the property in question was acquired after December 31, 1920, by the Corporation by the issuance of its stock in connection with a transaction described in section 112(b)(5), it follows that the basis to the Corporation is the same as it would be in the hands of the transferors.

Decisions will be entered under Rule 50.

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[3] SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * * * *

(8) Property Acquired by Issuance of Stock or as Paid-in Surplus.—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) * * *, or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor * * *.

APPENDIX B

Statutes Involved

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) Interest—All interest paid or accrued within the taxable year on indebtedness * * *.

* * * *

(n) Basis for Depreciation and Depletion—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 44. INSTALLMENT BASIS.

* * * *

(b) Sales of Realty and Casual Sales of Personalty.—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price * * *, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 44.)

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) Computation of Gain or Loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount Realized.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) Recognition of Gain or Loss.—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112.

(d) Installment Sales.—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

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(26 U.S.C. 1952 ed., Sec. 111.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * *

(b) Exchanges Solely in Kind.—

* * *

(5) Transfer to Corporation Controlled by Transferor.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation,

and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. * * *

* * *

(c) Gain from Exchanges not Solely in Kind.—(1) If an exchange would be within the provisions of subsection (b) * * * (5) * * * of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph * * * to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient, shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) Basis (Unadjusted) of Property.—The basis of property shall be the cost of such property; except that—

* * *

(8) Property Acquired by Issuance of Stock or as Paid-in Surplus.—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain

or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 113.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) Definition of Dividend.—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders; whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 115.)

APPENDIX C

Judgment, Case No. 5465

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5466

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5467

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5468

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5469

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5470

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5471

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5472

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5473

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5474

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5475

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

Judgment, Case No. 5476

Twenty-Third Day, March Term, Friday, April 19th, 1957.

Before Honorable Walter A. Huxman, Honorable Alfred P. Murrah and Honorable David T. Lewis, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.